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Weekly Market Flash

Does the correction have further to run?

June 20, 2021

This week the Federal Reserve (Fed) sped up its expected pace of policy tightening amid optimism about the labor market and heightened concerns of inflation. Oddly, despite the positive acknowledgment of the economy, US Treasury yields fell in response to below 1.50%, while the curve flattened massively, with the 30-year maturity rallying to the lows of the year. At the same time, the market seems to enjoy contradicting the Fed. As long as the Fed judged inflation to be transitory, and argued that rates would be firm until the end of 2023, the monetary curve predicted two hikes by the end of 2023. Now that the Fed has caved, market is almost overreacting: inflation expectations have fallen sharply, resulting in profit-taking on reflation trades and commodities.

Highlights

▪ St. Louis Fed President James Bullard followed the Fed's announcement and stated that he expects the Fed's first rate hike in late 2022 – again sooner than what the market was expecting.

▪ The flattening of the US Treasury yield curve took equity markets by surprise. This in turn weighed heavily on financial stocks that are negatively impacted by narrowing spreads between short-term and long-term rates.

▪ After the two latest disappointing labor market reports in the US, this week saw retails sale, industrial production, regional manufacturing surveys and unemployment claims all fall below expectations.

▪ The Italian press reported that the ECB had written a letter to Monte dei Paschi di Siena asking for clarification on the timing of the EUR2.5 billion capital increase, suggesting that the regulator is doubting the ability of Monte to pull off the structural solution.

"The bond market has already smelled an economic stall, with fiscal stimulus running into difficulties and stretched sentiment – and now we no longer have a friendly Fed."

Markets & Macro | Does the correction have further to run?

Fed-triggered selloff supported by multiple factors.

During the press conference following the FOMC meeting this week, Fed Chair Powell said that a discussion about scaling back bond purchases that were used to support financial markets and the economy during the pandemic has begun. Fed governors also released forecasts that show they anticipate two interest rate increases by the end of 2023, sooner than many expected.

On Friday, when markets were trying to digest the Fed's hawkish turn, the President of the St. Louis Fed reinforced the message. Bullard, who likes to place himself at the extremes of the consensus (either super dovish or super hawkish), strongly reiterated the concepts expressed at the conference, placing himself among those who would like to raise rates in 2022. In Bullard's view, the macro scenario has surprised the Fed in a positive way and action must be taken accordingly.

The Fed's new mood will likely have the effect of pushing other central banks to become more realistic toward stronger economic growth and the related inflation pressures. For instance, Norges Bank said, "the policy rate will most likely be raised in September" and hinted that a second increase was set for December. Canada's central bank also began to scale back its monthly bond buying in April. However, this shift is ironically occurring just as growth has likely peaked.

Our view: The bond market has already smelled an economic stall, with fiscal stimulus running into difficulties and stretched sentiment – and now we no longer have a friendly Fed. However, as we mentioned earlier, the market also seems to be contradicting the Fed. For instance, as long as the Fed judged inflation to be transitory, and argued that rates would be firm until the end of 2023, the monetary curve predicted two hikes by the end of 2023 and inflation risk, with breakevens flying and reflation trades in vogue. Now that the Fed has caved, and conceded that inflation prospects have deteriorated – and therefore stimulus will have to be withdrawn and rates raised sooner than priced in – inflation expectations have sharply dropped, with breakeven inflation and the long end of the curve falling.

"...while the Delta variant is not a game changer, because hospitalizations and deaths will likely remain low, it may become a factor dampening optimism..."

However, the market's selloff following the Fed meeting cannot only be explained by the central bank's decision. While it is obvious that this was the trigger, multiple reasons certainly contributed to the action, and have to be monitored in order to understand how much room the nascent correction might have:

- Covid-related newsflow has gradually deteriorated over the past few weeks. In the UK, new cases exceeded 10,000 daily for the first time since late February, mainly due to the Delta variant. Meanwhile in the US, the Delta variant has exceeded 13% of total cases. With two doses of vaccines, the risk of hospitalization falls by over 90% – but sadly, even in the UK, which leads the list of major countries, vaccine coverage is incomplete. The rise in hospitalizations, and more recently, in deaths (albeit marginally), draws in the unimmunized category. So while the Delta variant is not a game changer, because hospitalizations and deaths will likely remain low, it may become a factor dampening optimism, particularly at the height of the tourist season in the northern hemisphere.
- There is a possibility that investors are starting to discount a deterioration in economic growth over the coming quarters, at a time when the Fed has no ammunition, while the current demand/supply unbalances would not even allow for any relaxation in monetary conditions, or quite the opposite. After the two latest disappointing labor market reports, this week saw retails sale, industrial production, regional manufacturing surveys and unemployment claims all fall below expectations.
- As we recently reported, investor positioning may not be at extreme levels, but it is certainly not yet supportive of a sharp rebound either. On the fundamental side, valuations are high, with the CAPE multiple above 33, and earnings expectations for the year high. After 2020's 14% year-on-year drop in S&P 500 earnings, expectations for 2021 point to a 28% year-on-year rebound, with a further 10% year-on-year growth in 2022.

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- Geopolitical news were not at all positive in the last two weeks, but investors have apparently been uninterested so far. The agreement between the EU and the US on duties not only marks a truce on the Airbus-Boeing affair, but also lays the foundations for a joint commitment between Brussels and Washington against China. In addition to suspending the additional duties introduced in retaliation for subsidies to its aviation giants for at least five years, the agreement provides for an alliance to counter Beijing's rise in the technology sector.
- China's response to the statements at the end of the G7 and NATO summits was not long in coming. This week, in fact, Beijing carried out an incursion with 28 planes into Taiwan's Area Defence Identification Zone. The move comes just a few days after the G7 warned China to promote a peaceful resolution of its issues with Taiwan and as Taipei intensifies relations with the US.
- The technical setup sees a strong upward trend for the S&P 500 index, but with a strong resistance area at 4'250 (see Chart of the Week).

So, does this correction have further room to run? In our opinion, yes, as volatility has been low for a while, meaning that hedging activity was reduced. We believe it is difficult that the newsflow could improve much in the short term, excluding a positive earnings season – but with analysts' expectations already high. There is probably some excessive positioning to be eliminated. And the technical situation is being damaged by price action, with momentum lost and market internals (market's breath) having worsened in the past few weeks.

Chart of the week

After a very long rally, the S&P 500 index has started to show some signs of fatigue. The break of the trend line and the divergence in tops of the RSI would suggest a break of the steep late October bull trend. The bearish short-term trading signals warn for some caution in the short term, while the long-term rising trend remains intact.

“The bearish short-term trading signals (of the S&P 500 index) warn for some caution in the short term, while the long-term rising trend remains intact.”

Figure 1: S&P 500 Index

Source: Bloomberg, as at June 18, 2021.

Equities | Fed talks about talking about tapering

Curve flattening catches market by surprise.

While there are indeed differing interpretations of the Fed’s statement on Wednesday, the consensus view is that the central bank was surprisingly hawkish. First, Chair Powell acknowledged that at the meeting, policy makers were “talking about talking about tapering” – the first step toward raising rates. Second, the dots showed that Fed policymakers are expecting two rate hikes by the end of 2023, sooner than earlier projections. And third, as mentioned earlier, St. Louis Fed President James Bullard said that he expects the Fed’s first rate hike in late 2022 – again sooner than what the market was expecting.

But what took the equity markets by surprise more than the Fed’s hawkish statements was the flattening of the US Treasury yield curve. This in turn weighed heavily on financial stocks that are negatively impacted by narrowing spreads between short-term and long-term rates. Commodity stocks also came under pressure as a result of the exceptionally strong US dollar.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	33,290.08	-3.40%	-3.50%	9.79%
S&P 500	4,166.45	-1.87%	-0.81%	11.70%
Nasdaq	14,030.38	-0.26%	2.09%	9.21%
Euro Stoxx 50	4,083.37	-1.05%	1.10%	17.05%
Swiss Market	11,941.25	0.84%	5.08%	14.64%
FTSE 100	7,017.47	-1.62%	0.04%	10.48%
CAC 40	6,569.16	-0.41%	2.04%	20.48%
DAX	15,448.04	-1.56%	0.17%	12.61%
FTSE MIB	25,218.16	-1.94%	0.19%	15.01%
Nikkei 225	28,964.08	0.05%	0.36%	6.28%
Hang Seng	28,801.27	-0.11%	-1.00%	7.05%
CSI 300	5,102.47	-2.22%	-3.99%	-1.57%

Source: Bloomberg, as at June 18, 2021. Performance figures in indices' local currencies.

“We believe that the price actions of the week, if anything, highlight the extreme positioning that was in place across different asset classes – not just equities.”

Our view: There’s been a lot of positioning noise, but not enough signals. We believe that the price actions of the week, if anything, highlight the extreme positioning that was in place across different asset classes – not just equities. At the same time, the inflation picture remains unclear, even by Chair Powell’s own admission. Until then it would be premature to call an end to the value trade.

The genie is out of the bottle: this realization of peak positioning (equity allocations remain elevated, as highlighted in last week’s Market Flash) and peak policy is likely to keep market volatility elevated. Over the coming weeks, we will closely watch the fixed income market for clues on inflation and growth expectations, particularly the high yield corporate bond market, which had a muted reaction to the news from the Fed.

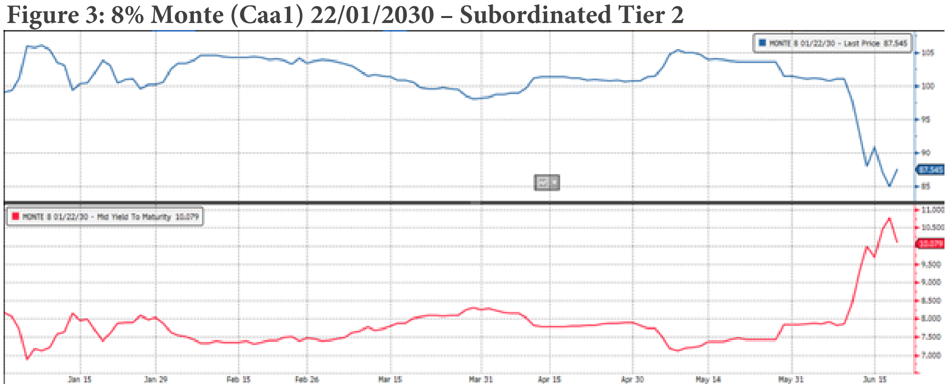
Fixed Income & Credit | Will a mini Monte be created?

"...the outcome for bondholders is very uncertain – ending up with a lower quality credit than UniCredit or leaving behind a mini Monte."

Bondholders face uncertain future.

On Wednesday, the Italian press reported that the European Central Bank had written a letter to Monte dei Paschi di Siena (Monte) asking for clarification on the timing of the EUR2.5 billion capital increase, suggesting that the regulator is doubting the ability of Monte to pull off the structural solution (M&A transaction with a stronger player). The reaction on the Tier 2 bonds has been heavy with prices down roughly 17%-20%.

Figure 3: 8% Monte (Caa1) 22/01/2030 – Subordinated Tier 2



Source: Bloomberg, as at June 18, 2021.

Our view: Two triggers appear to have driven the selloff. Firstly, press indications that the Ministero dell'Economia e delle Finanze has abandoned discussions with UniCredit in favor of a version of the 'stew' (spezzatino): break up the bank, let multiple lenders buy the pieces, and leave a mini Monte in the hands of the foundation. Secondly, a standalone solution and capital raise. Clearly, without a white knight such as UniCredit, the outcome for bondholders is very uncertain – ending up with a lower quality credit than UniCredit or leaving behind a mini Monte.

To add to the uncertainty is the looming EBA stress test next July. Even if the original plan submitted to the EC was one of a 'standalone' solution, whereby the bank would raise capital on its own, if the capital shortfall in the upcoming stress test is higher than the EUR2.5 billion capital strengthening planned and already included in the Italian budget law, the risk of "burden sharing" (a bond write-down) will increase.

While it is difficult to disentangle from rumors and denials issued, the reality is that banking in Italy is a politically manipulated sector with very little political will to seriously restructure, including cost cuts or impairments. Considering that a minimal-damage solution to Monte's predicament is a political priority, buying Tier 2 bonds on weakness is one way to potentially get good returns. However, buying based solely on moral hazard/trading is not without risks: if the negative path continues – and suffice to say that Monte is still structurally unprofitable and has generated losses of EUR24.5 billion since 2011 – one is left in an unwanted position.

"We believe the safest way to take advantage of the weakness is investing in senior preferred bonds where the contract does not provide for a bail-in."

We believe the safest way to take advantage of the weakness is investing in senior preferred bonds where the contract does not provide for a bail-in (loss of notional value). For example, MONTE 3 ⅝ 09/24/24 (Sr Preferred) priced at 103 for a yield of 2.64% offers a sharp pick up versus, for example, 2.5 BANCO BPM SPA (Sr Preferred), Ba2, 21/06/24 yielding 0.43%.

Week Ahead | Key events to watch for

- **The Fed will continue to dominate market movements next week**, with an abundance of Fed speakers taking center stage. There will also be US Treasury auctions with 2-year, 5-year and 7-year maturities offered.

- **In terms of economic data**, US regional surveys and durable goods orders will be published, along with the final reading of Q1 GDP. In Europe, PMIs will be released.

- **The Bank of England will also meet** next week. While no changes to policy are expected, the meeting will be watched closely for any changes in the language around inflation.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager